Konstantinos Alexandris Polomarkakis

University of Bristol Law School, UK
Wills Memorial Building
Queen's Road
Bristol BS8 1RJ
e: k.alexandris-polomarkakis@bristol.ac.uk

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Title:

The European VAT Oxymoron: A pragmatic solution for welfare, especially in times of crisis?

Abstract

VAT is an important but at the same time long neglected issue in social policy literature. The way in which taxes are levied has important implications for citizens in terms of equity and efficiency effects. Rate diversification is embedded in VAT planning across the EU, which enables Member States to address particular welfare objectives and tackle VAT's regressivity.

Nonetheless, for some, this undermines the uniformity and effectiveness of a pan-European VAT system comprised of the so-called ideal single-rate VAT structure which could bring more money into state budgets and, thus, allow for more generous welfare provision.

This paper evaluates arguments put forward by both sides, concluding that in times of crisis, where governments might advance VAT streamlining purely in order to deal with deficit constraints instead of fairer redistribution, the regime currently in place is the most pragmatic solution from a pro-welfare perspective.

Keywords
VAT, Welfare, Social Policy, EU, Crisis, Fiscal Welfare

Main Text

1. Introduction

More often than not, the role of taxation-related policies is being neglected in the course of welfare analysis. Taxation was the centrepiece of the fiscal welfare category of Titmuss's Social Divisions of Welfare, encompassing a broad array of tax allowances and benefits provided by the state to individuals or households. Titmuss himself highlighted its importance, arguing for an analysis to be undertaken to a similar extent as public expenditure on social policy is (Sinfield, 2013). Despite that, and as Orton and Davies note, "*fiscal welfare has been described as forming a hidden welfare state, and while taxation is one of the main ways in which governments affect the lives of citizens, studies of welfare pay remarkably little attention to its impact*" (2009, p. 33). It is an area that has not received much attention, particularly from social policy scholars, partly due to its deeply-embedded economic roots on the one hand and its not too straightforward, and somewhat understated, implications on welfare, on the other.

Even less attention was drawn to an aspect of tax policy that was relatively unknown during Titmuss's era, VAT. The latter constitutes, to put it crudely, a form of a general consumption tax applied to goods and services. Its popularity has increased considerably over the last decades, supported by prominent institutions and organisations (Schenk, Thuronyi, & Cui, 2015). In relation to welfare, VAT –and indirect taxation in general- have been associated with having regressive effects, taking away a higher income percentage from individuals and families at the lower end of the spectrum (Bennett, 2012). In an early study, among the first linking indirect taxation to welfare, Wilensky grouped countries according to the prevalence of visible or invisible taxes in their systems (1976). Nonetheless, it is rare to come across an elaborate analysis of VAT's potential implications. This is probably because it has long been considered as predominantly a business and corporate issue, something quite distant in terms of serving welfare goals or needs in the first place.

The irrelevance of VAT towards welfare might have held true in the past, but this is not the case nowadays, since various changes have occurred in VAT systems worldwide. An example of this is the EU where its founding members were among the frontrunners in adopting VAT. European VAT's ever-evolving nature has resulted in quite a complex regime, boasting clusters of different rates and exemptions, their complexity often leading to tax evasion and fraud (Terra and Wattel, 2012). This jeopardises VAT's *raison d'etre* as a means for generating public revenue and deprives state from money destined to be spent on its various functions, which typically include welfare and social expenditure. Thus, at least for some, evolution does not always equal sophistication insofar as the VAT realm is concerned.

Under such criticisms, the appraisal of European VAT's existing welfare dimensions becomes necessary. It is a salient issue, in particular during the current crisis era, which marked the starting point of serious welfare retrenchment, even in countries that were traditionally considered generous social spenders (van Kersbergen, Vis, & Hemerijck, 2014). Evaluating EU VAT is an arduous task due to its inherent complexities. Is the current regime, with its rate differentiation and exemptions, an altruistic knight or is it a Trojan horse distorting sincere welfare considerations, that might have otherwise been better served by a streamlined version of VAT?

The analysis will begin with a general overview of the EU VAT, setting its surrounding context and unpacking the ever-failing efforts towards harmonisation. Next comes an evaluation of the welfare-related arguments linked to the present state of the European VAT and, in particular, to the plethora of reduced rates and exemptions. This evaluation is based on a quadripartite framework comprising arguments related to vertical equity, positive externalities, labour-intensive industries, and reduced rates for remote geographical areas. Succeeding that, the regime's limitations are explained followed by considerations for a more harmonised and uniform VAT structure. Reflecting on all these, the conclusion wraps up the key features of my analysis, drawing ultimately, that, in times of crisis, the current regime, though far from perfect, might be proven the most pragmatic solution regarding welfare.

2. VAT Development in the EU and the Ideal VAT Structure.

EU Member States were among the pioneers in the introduction and subsequent application of VAT as a successor of turnover taxes, which used to be quite popular in the 1960s (Terra and Wattel, 2012). In fact, the first and second VAT directives entered into force as early as 1967,[1] leaving the drafting and implementing of a domestic VAT system to the Member States' discretion. As path dependence was prevalent, the rates adopted bore a striking resemblance to those previously in place under turnover taxes (Cnossen, 1982).

In the meantime, harmonisation was proclaimed as the way forward for European integration, and, more specifically, in the case of VAT, "*harmonisation … was perceived an integral part of achieving a common market*" (de la Feria, 2009a, p. 1). This initiated the discussions that led to the adoption of the sixth VAT directive.[2] Although progress had been made during that time, consensus was impossible to reach, postponing harmonisation to a future –yet unspecified- stage of the integration process.

The Internal Market might have acted as the carrot but the potential losses were not harsh enough of a stick to incentivise Member States to rapidly accept a streamlined VAT system. In that regard, the Commission initiatives were somewhat of a failure with the Approximation of VAT Rates directive of 1992[3] being the result of a political compromise and proliferating rate diversification (de la Feria, 2009b). It required Member States to apply a standard VAT rate above 15%. simultaneously with lower bands, albeit with restrictions for the introduction of new ones, something still applicable nowadays (Seely, 2013).

Further initiatives took place during the 1990s and early 2000s, but without success; to the contrary, there was a rise in VAT rate differentiation, attributed mainly to the labour-intensive services experiment (de la Feria, 2015). This inability to initiate a path departure, led to the enactment of more directives and other documents that attempted to consolidate VAT provisions and extended the applicability and scope of reduced rates (Ibid). The ongoing crisis could have been a driver for change, yet the Commission recently unveiled plans cementing the position of diversified VAT rates instead.[4]

[1] Council Directives 67/227/EEC of 11 April 1967 and 67/228/EEC of 11 April 1967.
[2] Council Directive 77/388/EEC of 12 May 1977.
[3] Council Directive 92/77/EEC of 19 October 1992.
[4] Communication: Commission Work Programme 2016, COM (2015) 610 final, of 27 October 2015; Communication: On an action plan on VAT - Towards a single EU VAT area - Time to decide, COM (2016) 148 final, of 7 April 2016.

Despite its inherent disparities, VAT belongs to the Community's own resources and forms part of the *acquis communautaire* of the EU, which is some sort of a paradox considering the absence of a unified system and the resilience of the old regime. This essentially means that there is a standard VAT rate ranging from 17% to 27%, but also either a single or a set of reduced rates from 5 to 18% depending on the Member State, a super reduced rate of below 5% in five countries, in addition to zero rate and/or a so-called parking one in others for certain goods and services, as a derogation from the 1992 directive. Moreover, VAT-exempt goods and services exist in a few countries. This gave ground to allegations that the established VAT amalgam in the EU has been transformed to a Gordian knot, jeopardising its envisaged neutral character and efficiency (Tutu, 2014).

The sluggish pace of change shows that at Member States domestic politics and national considerations prevail. "*Tax is ultimately the expression of political consensus and democratic debate*" (Owens, Battiau, & Charlet, 2011). Amongst the arguments advanced for keeping rate differentiation, welfare enjoys a prime place, due to the seemingly socially unjust character of VAT's neutrality. This encourages the manipulation of the latter's complexities, through indirectly attributing benefits to certain –vulnerable- social groups (Crawford, Keen, & Smith, 2009). Domestic politics are indeed important; as Wasserfallen notes, following the accession of "*the central and eastern European countries the prospects of harmonizing tax policy starkly decreased*" (2014, p. 420), reaffirming the thesis that the more the EU grows, the less chances are for –VAT- harmonisation to occur. This has been somewhat accepted by the Commission, as its latest communications, prioritising the decentralisation of rates, show.[5]

3. Evaluating the welfare considerations

3.1. The VAT and Welfare nexus

VAT is widely recognised as a rather regressive tax. This should not come as a surprise since its structure is intended to facilitate the collection of public budget revenue in a neutral, robust and efficient way. By being regressive VAT targets and negatively affects "*those with lower disposable incomes ('the poor') more than those*

[5] Ibid.

with higher disposable incomes ('the rich')" (Sykes, 2012, p. 173). This comes against the principles of equality and fairness, core underpinnings of any social policy narrative, as VAT's absolute burden is placed on poor people, particularly where a single rate system is the norm.

Yet, VAT is just one of the components of taxation systems. It, often, interacts with the rest of the applicable taxes and it is important to concentrate on that interplay in order to determine the final distributional impact therein. Nevertheless, according to some studies, VAT's regressivity is so pervasive that can negate many progressive effects of income taxation (Mahler and Jesuit, 2006). This is particularly relevant to industrialised developed economies. Some of the latter had to undertake tax reforms, triggered by the ongoing crisis and the need for fiscal consolidation. This resulted to a higher burden falling on the poor in both cases of VAT increases in Greece (Leventi, Levy, Matsaganis, Paulus, & Sutherland, 2010) and the UK (Browne and Levell, 2010).

Despite Wilensky's elaborate analysis on the contribution of indirect taxation in the financing of welfare, this remained a quasi-taboo issue, affecting governments' willingness to intervene (Kato, 2003). VAT might not have such a straightforward impact as direct taxation, but it still entails political costs. Thus, in order to alleviate its perceived regressive effects, reduced VAT rates for certain goods or services in combination with some exempt categories were advanced, bestowing VAT with some moderate progressivity (Caspersen and Metcalf, 1993). This was also a surreptitious way to maintain the remnants of the former turnover taxes system, whose concept of rate differentiation was inherited by the European VAT (de la Feria, 2015).

Assigning low and even zero rates or exemptions to food, medicine, culture and other goods or services was considered as a sign by the government of supporting equity and achieving egalitarian aims, by enabling some degree of redistribution to take place (Decoster, Loughrey, O'Donoghue, & Verwerft, 2009; Vermeend, van der Ploeg, & Timmer, 2008). Of course this is the case only if reduced VAT rates are passed on to consumers, something that does not always happen (Borowiecki and Navarrete, 2015). This system is contested through proposals for a more harmonised post-modern European VAT, which leaves almost no space for reduced rates (de la Feria and Krever, 2013).

What follows hereinafter is an analysis of European VAT's welfare dimension. The evaluative framework revolves around a typology of the core welfare rationales underpinning the current regime. These were construed through the key arguments invoked in order to support the existence of reduced rates and exemptions, as observed in seminal publications on the subject (Crawford et al, 2009; de la Feria, 2015; de la Feria and Krever, 2013; OECD 2014 to name a few). These four indicators are: vertical equity, positive externalities, labour-intensive industries and lower VAT rates for remote geographical areas.

3.2. Vertical Equity

The most cited indicator in terms of welfare-related goals is that of vertical equity a concept referring to fairness as between income groups (Decoster et al., 2009). It is related to the core concept of VAT being a regressive form of taxation that encumbers low income households the most (de la Feria, 2015). This category tends to include mainly food, as well as other goods or services such as medicine and healthcare, fuel, children's clothing, education etc. These exhibit low price elasticity, meaning that demand for them does not fluctuate with the change of their price, be it downwards or upwards (Leahy Lyons, & Tol, 2011). Expenditure on such necessities forms the largest share of low income household's budget making a case for the implementation of reduced rates therein (OECD, 2014).

This has found widespread acceptance by various stakeholders, who wish for basic goods to remain affordable across the EU. According to a study, higher VAT rates on goods or services targeted to high income households could be a useful tool, both theoretically and practically, in order to finance and compensate for this redistributive scheme (Copenhagen Economics, 2007). Another one also found that "*the exemption of food reduces inequality across all household types for all inequality measures* … [and] … *also raises social welfare in all cases except couples with no children and single non-retired people"* (Creedy, 2001, p. 472). It is worth mentioning that even its critics admit that a reduced rate should be maintained for the most essential goods (de la Feria, 2015).

Slovakia is the most recent example of a Member State reducing the VAT rate on basic foodstuffs to 10% on January 1st, 2016. This is a rather interesting development, bearing in mind that the country has been praised for unifying its VAT rate in the past, albeit with a proven increase of the VAT burden for households at the lower end of the income scale (Brook and Leibfritz, 2005). Slovakia follows the steps of the Romanian government that on June 1st, 2015 introduced a reduced VAT rate of 9% for essential food, which was previously taxed at the standard rate. Vertical equity seems to have emerged as a valid reason for lower VAT rates on essential items in those countries, which, up until now, followed the IMF and World Bank guidelines that promoted a streamlined single-rate VAT structure.

Furthermore, consultation regarding the Irish VAT found that moving food, oral medicine and children's clothes and shoes from the current zero rate to another one, would weigh down on low income households, with an increase of inflation between 1,51-2,36% (The Tax Strategy Group, 2011). The same would have been the case in the UK, Grown and Valodia argue, with the removal of the zero rate triggering a disproportionate incidence in the poorest households and those without any employed adult (2013). As a matter of fact, the UK government confirmed the social policy rationale behind zero and reduced rates for food, children's clothing, domestic fuel and power (Seely, 2013).

Promoting vertical equity through reduced VAT on medicine and pharmaceuticals, despite their obvious welfare implications, is more contested a category. The Association of Health Insurance companies in Germany has severely criticised the fact that the standard VAT rate is assigned to drugs, finding this a discrepancy in the reduced rates' system and following WHO studies highlighting the price inelasticity of medicines, (Creese, 2011). Further, some countries adopt different VAT rates for prescription and over-the-counter items. Such an examples is the UK, where in 2004 retailer ASDA and the Proprietary Association of Great Britain launched an unsuccessful campaign, claiming the degradation of people's welfare and wellbeing, by hindering those worse-off from being proactive about their health.

Estonia saw the increase of the reduced VAT rate, which also applies to pharmaceutical products. On top of the regressivity argument, more area-specific ones were invoked, such as the burden put on the access to medicines and healthcare in general, as certain products might become unavailable owing to the lack of demand

(Saluse and Aaviksoo, 2008). On a more positive note, since the beginning of 2015 medicine and pharmaceuticals enjoy a VAT rate of just 10% in the Czech Republic, benefiting from the introduction of a second reduced band for those goods perceived to enhance wellbeing, and which ought to be affordably available to all.

3.3. Positive Externalities

Another category is that of positive externalities and merit goods. According to de la Feria and Crever, "*it is based on the alleged benefits of subsidizing particular types of consumption that yield positive externalities, with* [reduced rates and] *exemptions seen as a way of increasing consumption of so-called merit goods*" (2013, p. 22). This might not seem *prima facie* as a welfare goal, but if an expansive definition of welfare is employed, the topic becomes quite relevant. It essentially comprises the majority of culture, sport and environment-related sectors, goods, services and events (de la Feria, 2015). Setting reduced rates on these correlates with the theory that the market cannot internalise their externalities, thus impeding their effective circulation and allocation (Borowiecki and Navarrete, 2015). This is precisely the reason why states intervene through their fiscal policies, including VAT planning, to try and tackle such complications.

Reduced VAT rates should eventually lead to lower prices, thus rendering the goods or services-in-question more affordable for poorer households, enabling the latter to actually benefit from such products, which can improve their educational level and reduce health and/or environment-related costs (Copenhagen Economics, 2007). An empirical example upholding that theory can be drawn from Sweden, where books taxed at the standard VAT rate where in low demand until 2001, when the government decided to include them in the reduced band. The outcome boosted book sales, as the VAT reduction was almost totally reflected in the price, allowing the state not to provide subsidies for bookstores in remote areas anymore (Ahlmark, 2003).

On the other hand, the same did not happen in Slovakia. There, the decrease of the applicable VAT rate from 19% to just 10% was not enough to drive demand, possibly because of the low levels of overall household income. This contradicts a cross-country EU study, which found that, usually, low VAT rates on books equal lower prices and drive consumption of these goods up, reaffirming the rationale behind their inclusion in the reduced rates' regime (Borowiecki and Navarrete, 2015).

Another merit good that also generates positive externalities is news production (van der Wurff, 2012), which, with very few exceptions, either belongs to the reduced rates' group or is VAT-exempt. In 2009, the Danish Ministry of Culture published a report on the issue, stating that if VAT on newspapers was increased, then consumers would bear the costs of a subsequent price hike (Ramboll Management Consulting, 2009). In the UK, the severe consequences of a potential VAT rate increase was the subject of some older studies, concluding that if this was to happen, then most regional newspapers would disappear and there would be a considerable fall in sales of national dailies (De Bens and Oestbye, 1998).

Regarding cultural events, in the Netherlands the VAT on theatre tickets increased by 13% in 2011, culminating in higher prices, and, subsequently in a sales drop, although the latter could be attributed to the general recession climate of the early 2010s (Borowiecki and Navarrete, 2015); the rate reverted back to 6% the following year. In a crisis-hit state, Spain, a VAT hike from 8 to 21% took place in 2013, with spectators numbers falling and jobs in the industry lost, showcasing the negative effects of fiscal austerity and the need for VAT differentiation therein.

Environment-related uses of VAT have turned it into a green form of taxation. By allocating reduced rates to energy-saving materials, those could become more accessible to the masses, alleviated a country's climate concerns and uplifting the welfare of its citizens. That was the rationale behind UK's Green Deal programme, which was, nonetheless, struck down by the CJEU.[6] The social policy clauses of the VAT directive were invoked by the UK to justify the reduced rates applicable, but to no avail.

3.4. Labour-intensive industries

The third category is that of labour-intensive industries. To a lesser extent it also includes locally supplied services as well as goods and services with high price elasticity. Its underpinning rationale comes from the negative impact higher VAT rates

[6] Case C-161/14 Commission v UK Report not yet published.

would have on employment. Carbonnier's French VAT study shows that prices change more dramatically here compared to merit goods (2005). It is a fairly recent addition at EU VAT planning, as. it was not until 1999 that the Council, through the so-called labour-intensive experiment, allowed Member States to apply reduced rates to an exhaustive list of such services on an optional basis.[7] Despite the dubiousness of its results, reduced VAT rates for the said category became permanent in March 2009.

A report found this category more justifiable on the basis of such services being substitutes for do-it-yourself activities, the reliance on which, if encouraged, would detrimentally affect market economy by diminishing the job opportunities for services such as hairdressing, minor repairs and domestic care (IFS, 2011; Copenhagen Economics, 2007). Market distortion can also happen by encouraging labour-intensive activities to move to the informal economy in order to evade high VAT rates (CFE, 2008). Furthermore, the resources of high-skilled individuals could be shifted to low-skill tasks, thus jeopardising market efficiency (Sørensen, 1997) and depriving them of their free time (OECD, 2014).

The two-fold aims of the application of reduced rates on this sector, namely to increase employment and confine informal economy, seem to have been attained in the case of the Isle of Man. A government report praised the success of a scheme mainly targeting housing and construction, which generated a higher tax take for the authorities, happier customers and improved profitability for the industry overall (Isle of Man Government, 2003). Interestingly enough, the UK never endorsed the idea of reduced rates for labour-intensive industries, being sceptical about their effectiveness (Seely, 2011).

The more encompassing Jobs Initiative in Ireland, initiated in 2011, has been fruitful in both passing through the VAT cut in most cases, and increasing employment at the same time (O'Connor, 2012). Another successful case are domestic services in France, which more than doubled between 1994-2004 partly due to their inclusion in the reduced VAT band (DARES, 2006). Portugal and Spain lowered restaurant VAT in 2016, in order to boost their labour markets.

[7] With Council Directive 1999/85/EC of 22 October 1999.

Another sector of labour-intensive industries is hospitality. Countries with high VAT rates there are less competitive, leading to problems not only for the hospitality industry, but for state budget as well, if a country's revenue heavily relies on tourism. The various newly-implemented VAT hikes in those areas in Greece might adversely impact its offering. An EU study, focusing primarily on the amusement park sector, but also on the hospitality industry in general, found that the introduction of lower rates provided women, young, unskilled and semi-skilled workers with opportunities of either full or part-time employment (IAAPA, 2014). Accordingly, reduced VAT rates essentially help to promote labour market activation and, thence, somewhat address certain of the so-called new social risks.

On a final note, the negative impact of high VAT rates on labour-intensive services is more pertinent to Member States with high levels of marginal income tax, such as Sweden. The combination of high rates on both creates an additional burden for high-income earners that impedes them from extensively consuming all available services, thus decreasing demand and, consequently, employment opportunities therein (OECD, 2011).

3.5. Additional rationale: Remote areas

Aside from the established categories explained *supra*, there can be additional social reasons for a Member State to adopt reduced rates. These, rarely figure in the relevant scholarship, as they are not as widespread as the other three. Amongst them, the paradigm of remote areas enjoying a privileged VAT regime involving reduced rates, is the most consistent one in encapsulating welfare considerations. As Kitchen and Slack note, "*governing remote areas raises different issues than governing urban areas because of the small size of the population, the lack of concentration of population, and the high cost of living*" (2006, p. 123).

Low levels of employment and income make fiscal governance difficult, as the fiscal base is fairly weak, and VAT's regressivity could potentially hit the population of those areas the hardest, impacting their already asthenic levels of welfare and wellbeing. Reduced VAT applied to most of the Aegean Islands in Greece, but is to be scrapped due to the country's third bailout, much to the uproar of the region's residents. A similar provision exists for Corsica in France, which also benefits from rates even lower than the mainland, in order to counterbalance the island's additional costs and market inefficiencies (Nicolai, 2010). The rationale bears similarities to vertical equity albeit taking into account the geographical peculiarities of those cases.

4. Limitations

Despite its positive impact on social policy, the regime in place certainly cannot be characterised as flawless. Its core limitations emanate in principle from the regressivity of VAT, which policy makers try to tackle through the introduction of reduced rates and exemptions, at the expense of its efficiency. Rate differentiation can impede VAT's optimal collection, and provide considerable fraud opportunities through the misclassification of products, thus potentially wounding public revenue allocated to social policy (Keen and Smith, 2006). Such views, conform to Ballard, Scholz, & Shoven's argument that a diversification of VAT rates, ends up producing a welfare loss compared to uniformity (1987). Empirical evidence from Italy attests that its VAT system became more redistributive when it abolished a rate band, underlining that "*reducing the number of VAT rates may be desirable even in the presence of distributional concerns"* (Liberati, 2001, p. 47). A French study found '*efficiency gains from reducing the gap between the full and reduced rates of VAT*' (André et al, 2015, p. 446).

Moreover, in countries with progressive income taxation and social security systems, any effort to tackle VAT regressivity by adopting a diversified rate structure may actually hinder the others' progressivity, rendering the whole concept inefficient towards welfare. In the following paragraphs, the focus of my analysis falls on the the limitations of the regime, shedding light on certain unsuccessful experiments and on the counter-argument refuting the thesis that rates' diversification leads to significant welfare gains.

Vertical equity reasons, while explanatorily the most reasonable in justifying reduced rates, are not completely unproblematic. The food sector can become a complicated landscape without convergence as to which products shall have reduced VAT, raising compliance costs (Copenhagen Economics, 2007). In some instances, such as goods high in sugar, people's wellbeing has been invoked for them to be on the standard rate, turning VAT into a quasi-sin tax, yet disregarding that poor are the ones hit the hardest by this choice (Snowdon, 2013). Consensus among Member States on framing an appropriate vertical equity category of goods or services is lacking, thus, crippling uniformity efforts and promoting an unequal VAT treatment of the same product across the EU (OECD, 2014). As if this was not enough, high income households also benefit from the lower rates quantitatively more compared to poorer ones.

Notwithstanding that, low-income households still gain substantially in proportion to expenditure, since "*they spend a significantly larger share of their income on food"* (Copenhagen Economics, 2007, p. 30). Yet regarding pharmaceutics, in some countries low income households have been replaced by middle income ones in benefitting the most in proportion to expenditure (OECD, 2014). Ireland experimented by cutting the standard VAT rate by 1% for vertical equity reasons, but after a year it backtracked, stating the cut had not been passed through (de la Feria, 2013). Removing reduced rates and providing low income households with direct transfers has been, therefore, proclaimed by various actors as a more efficient and socially just choice (OECD, 2010a). Crawford et al consider the current regime extremely weak and associate its persistence with the inability of politicians to 'market' any viable alternative (2009).

Things seem to be rather contentious regarding positive externalities and merit goods. An OECD study alerts that reduced rates on such goods or services might actually subsidise more their consumption by high-income households, instead of raising demand by poorer ones, leading to "*a so-called 'Mattheus effect' according to which social distribution flows from lower-income households to higher-income households*" (OECD, 2010b, p. 87). Regarding reduced VAT rates on newspapers, Kind and Moeen, argue that most studies favouring the current rate structure neglect to empirically ascertain the duality of the markets in which newspapers operate. (2015

Furthermore, another OECD study concluded that in the case of energy-efficient appliances, reduced VAT rates might lead to more sales of goods, which are otherwise energy-intensive and whose increased consumption may entail severe environmental repercussions (OECD, 2010c). In the UK, most new build is zero rated, whereas repairs and regeneration is mostly taxed in full, negatively impacting the ecology and cultural heritage of an area. In general, merit goods are considered the category the easiest to be abolished, following its anaemic underlying justifications. Portugal and Spain have already eliminated it (de la Feria, 2015). In Greece energy is about to move to a higher band, albeit books and theatre admissions will remain at the lowest rate. Such reforms materialised in countries under financial assistance programmes, which implies that they might be an outcome of EU's conditionality strategy rather than a pure VAT-streamlining initiative (Sacchi, 2015).

Regarding the labour-intensive sector, critics tend to refer to the disappointing results some of the past experiments have produced. The problem lies in the fact that when a reduced VAT rate is introduced, the price cut often does not correspond to the actual VAT rebate, thus not fueling demand. Two studies in Finland confirm this; the first dealt with the VAT cut on hairdressers (Kosonen, 2010), while the second with the restaurant industry (Harju and Kosonen, 2014). Both showed little reduction in prices and no effect whatsoever on either the demand or the employment levels therein. Large-scale transnational studies uphold the limited impact of reduced VAT rates on employment in these industries, blaming the inelastic demand that permeates them (European Commission, 2003 and OECD, 2011).

The homogeneity in the responses emanating from the different studies does not help to rebut their statements. As if this was not enough, OECD contested the reduced rates applying to the restaurant sector, claiming that high-income households far outweigh poorer ones in terms of restaurant expenditure (OECD, 2014). Vermeend et al argue that a reduction of direct taxes on labour could be 52% more effective than lower rates in addressing VAT's adverse effects on employment (2008). Further, reduced rates for labour-intensive industries, might trigger a downward harmonisation of VAT rates, with severe consequences for state budgets and welfare expenditure (Leibfried, 2015). Although a bit far-fetched, this would mainly impact the Nordic welfare states, such as Denmark, which finance their generous welfare spending predominantly through high indirect taxation (Hagen, Norrman, & Sørensen, 1998).

Another limitation of the scheme lies in the complexity of classifying what falls under reduced rates or is exempt. This might hamper the competitiveness of welfare-related organisations, especially if they belong to the private or third sector. For example, the construction of a nursing home in the UK can be VAT exempt under certain conditions, namely the provider being a charity, a public body or state-regulated. Conversely, if private providers do not conform to any of these typologies, they will have to entail higher costs, and thus be less competitive, unless their services are contracted-out to local authorities. Otherwise, welfare users would have to incur higher charges due to the VAT passing on to them (Hall, 2014).

Such rationales actually hinder welfare provision by distorting the welfare mix. People who can no longer afford private providers would have to resort to the state, elevating the associated costs for state provision. Moreover, private actors would encounter inadequate fiscal opportunities to become welfare providers on their own and equally compete with their public counterparts (Taylor-Gooby, 2013). The paradox of VAT rate diversification also exacerbates the education landscape in England, where sixth-form colleges are treated differently to secondary schools (HM Government, 2015). This depicts a farcically arbitrary system that whimsically classifies similar establishments in separate bands.

5. Is harmonization a viable solution at times of crisis?

At this point one might suggest that an overhaul is overdue. Cnossen has advocated for that since the late 1990s, by putting forward the solution of a uniform VAT rate, following the paradigm of New Zealand (1998). This is backed by both a notable part of the academic community (Creedy, 2011; de la Feria and Crever, 2013) together with several international organisations (OECD, 2014); for them incorporating welfare considerations in VAT planning simply fares badly. Instead, they support VAT harmonisation across the EU, with domestic systems mitigating any negative welfare effects through other forms of taxation, such as direct or wages taxes (Levell, Roantree, & Shaw, 2015).

Of course harmonisation and uniformity do not come without pitfalls. According to the Europeanisation literature, compliance levels among Member States vary, meaning that at least during the first stages of a pan-European VAT implementation process disparities would be prevalent among country clusters (Falkner and Treib, 2008). This could be attributed to various factors inside a Member State that might lead to a misfit between the envisioned project and reality (Treib, 2006). The most important among them is either the low reform capacity of a country (Heritier et al., 2001), or certain institutional veto players, who may block willing governments from realising their agendas (Haverland, 2000; Tsebelis, 2002). In turn, this is even more likely to happen in policy-making, whose inherent complexities tend to deter the launch of ground-breaking ventures (Stevens, 2011), but also whenever national sovereignty 'feels threatened' by supranational initiatives, particularly if fiscal policy is concerned (Enderlein Funke, & Lindner, 2015).

In the relevant section, I briefly explored the failed attempts towards VAT harmonisation in the EU, showing a strong path dependence. Nonetheless, even if harmonisation became reality, a series of different problems would emerge, particularly in regards to the current crisis that calls for welfare retrenchment, as part of the general cutbacks on public spending (Greve, 2012). Subsequently, what has long been considered as the social acquis of many European countries is now constantly being eroded. In a retrenchment period it is doubtful that measures enhancing progressivity would be enacted. Instead VAT rates are constantly increasing coupled with extended cuts in social expenditure, exacerbating regressivity in lieu of trying to make up for it (Irvin, 2013). Under such climate where upwards social mobility is halted, VAT remains regressive life-long, despite affirmations to the contrary (Levell, Roantree, & Shaw, 2015); pro-uniformity studies rarely adequately tackle the regressivity question.

Things, thus, would look bleaker if VAT was streamlined. Different countries, in the absence of a common EU social policy, compensate their poor differently, making it dubious that low income households would come unscathed after a suppression of the reduced rates. Things become even more unsettling if one takes into account the shift towards neoliberal practices as the general direction an increasing number of Member States is adopting in regards to welfare (Featherstone, 2004). In Ireland VAT streamlining took place at the same time as the intensification of the liberal characteristics of the Irish welfare state (Dukelow, 2011). A similar direction was followed in the majority of the crisis-hit Member States around the Mediterranean. A point has been reached where harmonisation rather than leading to a fairer redistribution through higher government revenues, might be more of a tool in solving public deficit-related issues, whilst advancing the neoliberal project through VAT's regressivity (Cooper et al, 2010).

6. Conclusion

After having evaluated the current EU VAT regime, it becomes obvious that it is far from perfect. While welfare is undoubtedly a goal therein, and such direction was followed in the planning process, this is not without the constraints set out *supra*. All rationales behind preserving the various reduced rates and exemptions centred around vertical equity, positive externalities and labour-intensive industries seem to serve social policy well. It could be argued that they incorporate a sound rationale justifying the existence of rate diversification in the EU, by trying to counterbalance most of the regressivity that VAT displays.

Nevertheless, the VAT rate structure that is in place comes with a series of limitations, distorting its function. What seems to be common among them is that, in general, high-income households having the highest purchasing power tend to benefit quantitatively more. This *de facto* weakens some of the progressivity assumptions entrenched to the current regime. Yet it should not detract someone from the more socially meaningful progressive effects reduced rates and exemptions display towards poorer households. Another alleged problem is the high compliance costs associated with the complexity of classifying something among numerous VAT bands. Overall, the European VAT system is a multi-level oxymoron; even though it tries to be fair and redistributional this does not come without considerable efficiency costs.

Despite its limitations, this oxymoron might as well be the structure that best advances welfare considerations in VAT. After having briefly contemplated on its potential alternatives under the ongoing global developments, insofar as social policy is concerned, the current regime, with the embedded rate diversification and list of exemptions, remains the most realistically viable solution. And it is a pragmatic solution for welfare, not only for the reasons described here, but also because it has been proven as an acceptable political solution against VAT's regressivity. For what it is worth, no comparable alternative has been put forward yet. People and –some- policy-makers alike perceive it as serving a moderately pro-poor policy (Alt, Preston, & Sibieta, 2009).

It is easy for individuals to acknowledge that they directly benefit from the application of reduced rates. Thence, VAT rate differentiation gains simultaneously its political and social endorsement, both necessary for its uninterrupted implementation.

That does not mean that rethinking the current regime is out of the question. Ideally, a streamlining of the various rates in order to reduce their complexities and compliance costs shall happen, yet without neglecting the interests of poorer households protected by maintaining the lower bands. After all, despite its shortcomings, the European VAT has welfare considerations at its heart, safeguarding those in need from its negative repercussions. The fact that high income-earners might also benefit shall not undermine lower rates' social function. When the core question revolves around little or no welfare, it is better to try and shelter what is left of it. VAT planning –in the EU and elsewhere- should follow that direction.

6315 words (8488 with bibliography)

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